Nos. 78-606 and 78-607

In the Supreme Court of the United States

OCTOBER TERM, 1978

PACIFIC TELEPHONE AND TELEGRAPH COMPANY, PETITIONER

v.

THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA, ET AL.

GENERAL TELEPHONE COMPANY OF CALIFORNIA, PETITIONER

v.

THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA, ET AL.

ON PETITIONS FOR A WRIT OF CERTIORARI TO THE SUPREME COURT OF CALIFORNIA

MEMORANDUM FOR THE UNITED STATES AS AMICUS CURIAE

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QUESTION PRESENTED

The United States will discuss the following question:

Whether the California Public Utilities Commission erred in holding that its ratemaking orders preserved petitioners' eligibility for the investment credit and accelerated depreciation for federal income tax purposes under Sections 46(f) and 167(*l*) of the Internal Revenue Code of 1954.

INTEREST OF THE UNITED STATES

In 1969 and 1971, Congress enacted Sections 167(*l*) and 46(f) of the Internal Revenue Code of 1954, respectively, which deal with the eligibility of regulated public utilities for accelerated depreciation and the investment credit. Section 167(*l*) provides that a regulated public utility that had not previously claimed the benefits of accelerated depreciation could not do so unless it used the "normalization method of accounting" for ratemaking purposes. The use of such a method of accounting insures that the benefits of the utility's depreciation deductions will be allocated equally between its present and future customers. Section 46(f) similarly places certain limits upon eligibility for the investment tax credit. With respect to petitioners, Section 46(f)(2) permits the credit only on the condition that they reflect that credit in their cost of service for ratemaking purposes no faster than ratably over the useful life of their property.

In these cases, the California Public Utilities Commission issued ratemaking orders based on methods of accounting that it concluded would "maintain the eligibility of the utilities to use accelerated depreciation and ITC [investment tax credit] and comply with the requirements of the Internal Revenue Code relating to [petitioners]" (J. App. B, 49A-50A).[1] However, the Internal Revenue Service has ruled that the Commission's assumption was erroneous and that methods of accounting it required would in fact destroy petitioners' eligibility because they do not provide for normalization (in the case of depreciation) or an allowable ratable reduction (in the case of the investment tax credit) (J. App. D, 95A-131A; J. App. E, 133A-142A).

As the official charged with the responsibility of administering and enforcing the federal income tax statute, the Secretary of the Treasury agrees with petitioners that the interpretation of the Internal Revenue Code by the California Public Utilities Commission, upheld by the court below, requires review by this Court at this time in order to put to rest uncertainty as to a fundamental issue potentially affecting the tax liabilities of all regulated public utilities. If the decision below is correct, petitioners would be subject to the rate adjustments ordered by the Commission but would be eligible for the benefits of accelerated depreciation and the investment credit

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[1] "J. App." refers to the Joint Appendix filed on behalf of both petitioners.

that they have claimed. But as matters now stand, petitioners are simultaneously subject to the rate-making orders of the Commission and the assertion of massive federal income tax deficiencies exceeding $1 billion in accordance with the Treasury's rulings. If this Court were to decline review and the Treasury's ruling position is ultimately sustained in a federal tax proceeding, petitioners would suffer the burden of lower rates (based on the assumption of eligibility for the federal tax benefits) and disallowance of those tax benefits. Moreover, if the California Public Utilities Commission's interpretation of Sections 167(*l*) and 46(f) remains unreviewed while the Treasury continues to adhere to its position, the decision below is likely to be followed by other state regulatory bodies to the detriment of similarly-situated public utilities. The United States believes that the continued existence of this conflict between the Treasury and the state regulatory commissions threatens to work an enormous hardship upon the public utilities sector of the economy and to disrupt the stability of the capital markets as affected utilities must undertake borrowings to meet these large-scale federal tax obligations.

STATEMENT

These state public utility ratemaking cases uniquely present legal questions that solely involve the proper interpretation of two federal tax statutes.

Section 167(*l*) of the Internal Revenue Code of 1954, which was enacted as part of the Tax Reform

Act of 1969, permits a regulated public utility to claim the benefits of accelerated depreciation if it had not previously done so on the condition that it use a "normalization method of accounting" for rate-making purposes. Section 46(f) of the Code, which was enacted in 1971 as part of the restoration of the investment credit, similarly conditions a utility's eligibility for the credit upon the computation of its cost of service for ratemaking purposes by ratably reducing such cost by the tax credit amortized over the useful lives of its assets. By requiring normalization of depreciation and ratable accounting of the investment tax credit, Congress sought to avoid the loss of federal revenues that would otherwise occur if these tax benefits were immediately "flowed through" to the current ratepayers thereby resulting in reduced rates and reduced taxable income. See H.R. Rep. No. 91-413 (Pt. 1), 91st Cong., 1st Sess. 131-132 (1969); S. Rep. No. 91-552, 91st Cong., 1st Sess. 172 (1969); H.R. Rep. No. 92-533, 92d Cong., 1st Sess. 26 (1971); S. Rep. No. 92-553, 92d Cong., 1st Sess. 39 (1971).

In these proceedings, the California Public Utilities Commission was acutely conscious of the need to preserve petitioners' eligibility for accelerated depreciation and the investment credit. It stated (J. App. B, 22A):

> Eligibility is the first issue to be determined. To render a decision which attempts to resolve these cases without regard for this issue might create problems for these utilities, their rate-

payers, the Commission, and the Courts that even exceed (both in scope and complexity) the problems that we are attempting to resolve in this decision. In the final analysis a loss of eligibility to the utilities would not only create service problems (though certainly not of the scope described by Pacific's) but would create staggering financial problems to be ultimately borne by the ratepayers whose interests we are attempting to redress. We believe that eligibility for these tax benefits should be maintained and proceed on this basis.

The Commission thereupon took petitioners' accelerated depreciation into account pursuant to a method of accounting it characterized as the "averaged annual adjustment" (AAA method) (J. App. B, 25A). It "believe[d] [that its] method [was] direct, simple, and in full compliance with the applicable federal law" so that [e]ligibility [for accelerated depreciation] will be maintained * * *" (J. App. B, 27A). In taking the investment credit into account for ratemaking purposes, the Commission adopted a method that it believed "to encompass all the factors [it] desire[d]," which it characterized as "the annual adjustment" (2A method) (J. App. B, 30A).

Petitioners sought a continuation of the then-existing rates until such time as they could seek a ruling from the Internal Revenue Service as to whether the Commission's methods would preserve their eligibility for accelerated depreciation and the investment credit (J. App. B, 39A). Although the Commission acknowledged that "[w]e have here a

case of first impression under the tax laws" (J. App. B, 40A), it rejected petitioners' request for delay on the ground that "an advance ruling within a reasonable time [was] not probable" (*ibid.*). It therefore concluded that the AAA and 2A methods of accounting "maintain the eligibility of the utilities to use accelerated depreciation and ITC [investment tax credit] and comply with the requirements of the Internal Revenue Code relating to [petitioners]" (J. App. B, 49A-50A).

The Commission reached its decision by a 3-2 vote. Of the three members in the majority, two concurred noting that "[t]he *ultimate* verdict on the validity of this decision will have to be made in the United States Supreme Court and the sooner that is accomplished the better off all participants will be" (J. App. B, 70A; emphasis in original). The two dissenting members were of the view that the Commission should have allowed petitioners a reasonable period of time to obtain a ruling from the Internal Revenue Service. They concluded that it was "imprudent of the Commission not to exhaust available consultive procedures and thus safeguard the state against the catastrophic consequences of ineligibility" (J. App. B, 72A).

Less than three weeks after the Commission issued its order, petitioners sought rulings from the Internal Revenue Service as to their eligibility for accelerated depreciation and the investment credit under the AAA and 2A methods devised by the Commission. Nine and ten months later, the Internal Revenue

Service issued letter rulings to petitioners respectively concluding that the AAA method was not a normalization of accounting under Section 167(*l*) of the Internal Revenue Code (J. App. D, 95A-131A), and that the 2A method was inconsistent with the requirements of Section 46(f) of the Code (J. App. E, 133A-142A). Accordingly, the Service concluded that the Commission's order destroyed petitioners' eligibility for accelerated depreciation and the investment credit.

Upon reciept of the Internal Revenue Service's ruling with respect to accelerated depreciation, petitioners asked the Commission to join them in requesting the Supreme Court of California (where petitions for review had been filed) to remand the cases to the Commission in light of the Internal Revenue Service ruling. The Commission declined, stating that the ruling "adds nothing new to these proceedings" (78-607 Pet. 15).

The Supreme Court of California denied petitions for review.[2] One member of the court was of the opinion that the petition should have been granted (J. App. A, 1A-2A).[3]

[2] Under California law, the California Supreme Court's order denying review was a decision on the merits. The jurisdiction of this Court is therefore properly invoked under 28 U.S.C. 1257(3). See *People* v. *Western Air Lines, Inc.*, 42 Cal.2d 621, 630, 268 P.2d 723, 728, appeal dismissed, 348 U.S. 859 (1954). See also *Napa Valley Electric Co.* v. *Railroad Commission*, 251 U.S. 366 (1920).

[3] The Internal Revenue Service's ruling with respect to petitioners' eligibility for the investment credit was issued on

DISCUSSION

These cases present federal tax questions of enormous potential fiscal significance to regulated public utilities that should be resolved by this Court.

1. In *FPC* v. *Memphis Light, Gas & Water Division*, 411 U.S. 458, 459-461 (1973), this Court reviewed the background that led to the enactment of Section 441 of the Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 625, which added Section 167(*l*) to the Internal Revenue Code of 1954. Section 167, as originally enacted in 1954, permits a taxpayer to compute depreciation of its business assets either on a straight-line or accelerated basis. The straight-line method yields an equal annual depreciation allowance over the useful life of the asset. The accelerated or liberalized methods provide for depreciation allowances in the early years that are greater than the straight-line method but which steadily decrease over the useful life of the asset.

Federal income taxes are properly included as an expense by a regulated public utility in computing its cost of service for ratemaking purposes (see 411 U.S. at 460 n.2). As originally enacted in 1954, the Internal Revenue Code provided no rules governing the manner in which a public utility was to compute its federal tax expense for ratemaking purposes if it elected to use accelerated depreciation. Accordingly,

July 27, 1978, two weeks after the California Supreme Court denied review of the Commission's orders in these cases (J. App. A, 1A-2A; J. App. E, 133A).

the regulatory commissions required utilities using accelerated depreciation for tax purposes to use the same method for calculating their cost of service and, thus, to "flow through" the resulting tax savings to their customers (*id.* at 460).

In 1969, Congress became concerned with the loss of tax revenues that resulted from the combined effect of accelerated depreciation (leading to higher tax deductions) and flow-through for fixing rates (leading to lower rates and therefore lower gross revenues). As a result, Congress added Section 167(*l*) to the Internal Revenue Code, which generally provides that utilities that had not previously used accelerated depreciation could not do so unless they used the "normalization method of accounting" for ratemaking purposes. Under the normalization method, a utility computes its cost of service as if it were using straight-line depreciation, and "must make adjustments to a reserve to reflect the deferral of taxes resulting from the use" on its tax return of an accelerated method of depreciation. Section 167(*l*)(3)(G), J. App. C, 82A-83A. In other words, the difference between the taxes actually paid and the higher taxes reflected as a cost of service for ratemaking purposes is placed in a deferred tax reserve account. This method was designed to avoid giving the present customers of a utility the benefits of tax deferral attributable to accelerated depreciation and make the deferred taxes available to the utility for investment.

The statute is silent as to how the deferred tax reserve is to be treated for ratemaking purposes. Treasury Regulations, Section 1.167(*l*)-1(h)(6), J. App. C, 88A-93A, permits the reserve account to be excluded from the utility's base to which its rate of return is applied. The theory of this exclusion is that the amount of the deferred taxes is treated as an interest-free loan to the utility and that the utility is not entitled to a return on that part of its capital base that is not provided by its shareholders. However, Section 1.167(*l*)-1(h)(6)(i) of the Regulations is explicit as to the proper amount of the exclusion from the rate base. It provides that "a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes under section 167(*l*) which is excluded from the base to which the taxpayer's rate of return is applied * * * exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's tax expense in computing cost of service in such ratemaking."

The Commission's AAA method of accounting runs afoul of this explicit prohibition of the Regulations. It does not limit the exclusion to the utility's deferred tax reserve in the test year, *i.e.*, the period used for computing the rate base and cost of service. To the contrary, the Commission's method provides for an exclusion from the rate base by the estimated average of the deferred tax reserve for the test year and the three succeeding years. Given the fact that peti-

tioners continue to make additions to their plant (see J. App. B, 58A-59A), the Commission's method unquestionably results in an exclusion that "exceeds the amount of [the] reserve for deferred taxes for the period used," *i.e.*, the test year. This is not a normalized method of accounting. See Treasury Regulations, Section 1.167(*l*)-1(h)(6)(iv), Ex. (1), J. App. C, 89A-90A. By hypothesizing a larger deferred tax reserve than in fact exists, the Commission has required a partial "flow through" of the tax deferral to the utilities' present customers in derogation of Congress' intent in enacting Section 167(*l*).

2. The Commission's 2A method of taking the investment credit into account also thwarts the congressional purpose of providing a tax incentive to modernize plants by prohibiting the pass-through of the credit to the utility's current ratepayers. Thus, Section 46(f) provides that no investment credit will be allowed with respect to any public utility property if (1) the utility's cost of service for ratemaking purposes is reduced by more than a ratable portion of the allowable credit over the useful life of the property or (2) the utility's rate base for ratemaking purposes is reduced by reason of any portion of the allowable credit (see J. App. C, 76A).

Here, the Commission's 2A method took a ratable portion of the investment credit into account in computing cost of service for the test year based upon projected capital additions. However, the Commission gave no recognition to the fact that if the utility has an increased credit based upon estimated capital additions for succeeding years, it necessarily also has increased depreciation expenses and an expanded rate base. By freezing petitioners' depreciation and rate base at test year levels but increasing the credit (and thereby reducing the cost of service) for succeeding years, the Commission has reduced the cost of service "by more than a ratable portion of the credit allowable" in contravention of Section 46(f)(2)(A). The result will be disallowance of petitioners' claimed investment tax credits.

3. In urging review of the decision below, we are not unmindful of the fact that this Court generally grants certiorari in federal tax cases only where there is a conflict of decisions. See, *e.g.*, opinion of Mr. Justice Stevens respecting the denial of the petition for certiorari in *Singleton* v. *Commissioner*, No. 78-78 (Oct. 30, 1978), slip op. 4. Here, the federal tax questions presented are concededly technical and have been addressed only by the decision below in a state ratemaking proceeding and by the Commissioner of Internal Revenue in private letter rulings to petitioners. Normally, these facts would call for further development of the questions by the federal courts prior to this Court's exercise of its discretionary review.

But these are unusual cases. As matters now stand, the decision below and the Internal Revenue Service are on a collision course that threatens the financial stability of all regulated public utilities in California and potentially affects other similarly-situated companies. If, as we submit, the decision below is based

on erroneous interpretations of the applicable federal tax law, a delay in establishing that fact with finality will result in the simultaneous subjection of the utilities to lower rates based upon the false assumption of eligibility for substantial tax benefits and the disallowance of those benefits. Thus, the resolution of the conflict between the decision below and the Internal Revenue Service cannot practicably await the outcome of the federal tax litigation with respect to the deficiencies that inevitably will ensue. A decision with such far-reaching impact upon a vital sector of the nation's economy calls for review by this Court.

CONCLUSION

The petitions for a writ of certiorari should be granted.

Respectfully submitted.

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